



Legislative Audit Division

State of Montana

Report to the Legislature

October 2006

Financial-Compliance Audit

For the Two Fiscal Years Ended June 30, 2006

Department of Natural Resources and Conservation

This report contains eight recommendations. Issues addressed in the report relate to:

- ▶ **Practices that violate trust agreements, trust duty and state law.**
- ▶ **Improper use of appropriation authority.**
- ▶ **Noncompliance with state law.**

This report also contains a disclosure issue related to trust land administration, addressing the basis used to calculate the Trust Land Administration Account maximum appropriation and deposit amounts for the Capitol Building Trust.

**Direct comments/inquiries to:
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Government Auditing Standards, the Single Audit Act Amendments of 1996 and OMB Circular A-133 require the auditor to issue certain financial, internal control, and compliance reports. This individual agency audit report is not intended to comply with these reporting requirements and is therefore not intended for distribution to federal grantor agencies. The Legislative Audit Division issues a statewide biennial Single Audit Report which complies with the above reporting requirements. The Single Audit Report for the two fiscal years ended June 30, 2007, will be issued by March 31, 2008. The Single Audit Report for the two fiscal years ended June 30, 2005, was issued on March 6, 2006. Copies of the Single Audit Report can be obtained by contacting:

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October 2006

The Legislative Audit Committee
of the Montana State Legislature:

This is our financial-compliance audit report on the Department of Natural Resources and Conservation for the two fiscal years ending June 30, 2006. The report contains a qualified opinion on the department's financial schedules. Included in this report are eight recommendations and a disclosure issue primarily related to trust land administration and compliance with state law. The department's written response to the audit recommendations is included in the audit report at page B-3.

We thank the director and her staff for their cooperation and assistance throughout the audit.

Respectfully submitted,

/s/ Scott A. Seacat

Scott A. Seacat
Legislative Auditor

Legislative Audit Division

Financial-Compliance Audit

For the Two Fiscal Years Ended June 30, 2006

Department of Natural Resources and Conservation

Members of the audit staff involved in this audit were

Jeane Carstensen-Garrett, Rick Eneas, John Fine, Cindy S. Jorgenson,
Laura L. Norris, Paul O'Loughlin, Vickie Rauser and Jeff Tamblyn.

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Elected, Appointed and Administrative Officials

State Board of Land Commissioners

Brian Schweitzer, Governor

John Morrison, State Auditor

Brad Johnson, Secretary of State

Linda McCulloch, Superintendent of Public Instruction

Mike McGrath, Attorney General

Administrative Officials

Mary Sexton, Director

Ann Bauchman, Centralized Services Division Administrator

Ray Beck, Conservation and Resource Development Division
Administrator

Bob Harrington, Forestry Division Administrator

Tom Richmond, Oil and Gas Conservation Division Administrator

Vacant, Water Resource Division Administrator

Susan Cottingham, Reserved Water Rights Compact Commission
Program Manager

Tom Schultz, Trust Land Management Division Administrator

Tim Hall, Chief Legal Counsel

Administratively Attached Boards, Commissions & Committees

Board of Water Well Contractors

Board of Oil and Gas Conservation

Reserved Water Rights Compact Commission

Rangeland Resources Committee

Drought Advisory Committee

Resource Conservation Advisory Council

Montana Grass Conservation Commission

Flathead Basin Commission

Department of Natural Resources and Conservation

This report documents the results of our financial-compliance audit of the Department of Natural Resources and Conservation (department) for the two fiscal years ended June 30, 2006. The previous report contained fifteen recommendations to the department. The department implemented twelve, partially implemented one, and did not implement two of the recommendations.

This report contains eight recommendations and one disclosure issue. The recommendations address trust land administration practices that violate trust agreements, trust duty, and state law; improper use of appropriation authority and compliance with state law. The disclosure issue addresses the basis used to calculate the Trust Land Administration Account maximum appropriation and deposit amounts for the Capitol Building Trust. The department's written response to the audit recommendations begins on page B-3.

We issued a qualified opinion on the financial schedules contained in the report. This means the reader should use caution when relying on the financial information presented and the supporting accounting records.

The listing below serves as a means of summarizing the recommendations contained in the report, the department's response thereto, and a reference to the supporting comments.

Recommendation #1

We recommend the department:

- A. Seek legislation to provide a funding source for the administrative costs of the Morrill Trust.

Department Response: Concur. See page B-3.

- B. Seek legislation to exclude the Morrill Trust from administrative account deposit requirements.

Department Response: Concur. See page B-3.

- C. Repay the \$507,643 inappropriately withheld from Morrill Trust revenues, plus accrued interest, to the Morrill Trust and its beneficiary, Montana State University.

Department Response: Partially concur. See page B-3.

Report Summary

- D. Repay the \$244,900 inappropriately withheld from Common School, University of Montana, Montana State University – second grant, Montana Tech, State Normal School, School for the Deaf and Blind, State Reform School, and Capitol Building Trust revenues, plus accrued interest, to the trusts and their beneficiaries. 10

Department Response: Partially concur. See page B-3.

Recommendation #2

We recommend the department:

- A. Establish procedures to allocate administration costs affecting a single trust to the affected trust.

Department Response: Concur. See page B-3.

- B. Repay the \$15,406 inappropriately withheld from University of Montana, Montana State University – second grant, Montana Tech, State Normal School, School for the Deaf and Blind, and Capitol Building Trust revenues, plus accrued interest, to these trusts and their beneficiaries..... 12

Department Response: Concur. See page B-3.

Recommendation #3

We recommend the department:

- A. Seek legislation to establish a mechanism for funding the Trust Land Administration Account when initial allocations exceed maximum deposit amounts.

Department Response: Concur. See page B-4.

- B. Repay the \$215,631 inappropriately withheld from Common School Trust revenues, plus accrued interest, to the Common School Trust and its beneficiaries. 13

Department Response: Do not concur. See page B-4.

Recommendation #4

We recommend the department:

- A. Maintain expenditure records in sufficient detail to identify the administration costs incurred for the benefit of each trust, and

Department Response: Concur. See page B-4.

Report Summary

- B. Evaluate the expenditure data to ensure each land trust's administration charges are reasonable and, if necessary, develop another allocation method that results in reasonable charges. 16

Department Response: Concur. See page B-4.

Recommendation #5

We recommend the department discontinue diverting revenues of one trust to pay administrative costs allocated to other trusts 18

Department Response: Concur. See page B-4.

Recommendation #6

We recommend the department limit charges to its appropriations to purposes specified in appropriation laws. 18

Department Response: Concur. See page B-4.

Recommendation #7

We recommend the department process surface and ground water rights applications in the timeframes required by state law. 19

Department Response: Concur. See page B-5.

Recommendation #8

We recommend the department comply with section 17-1-102, MCA, by establishing procedures to ensure distributions of unrealized investment losses are properly classified on the state's accounting records. 20

Department Response: Concur. See page B-5.

Introduction

Introduction

We performed a financial-compliance audit of the Montana Department of Natural Resources and Conservation (department) for the two fiscal years ended June 30, 2006.

The objectives of this audit were to:

1. Determine the department's compliance with state laws and regulations.
2. Provide department management with recommendations for improvement in management and internal controls.
3. Determine if the department's financial schedules fairly present the results of operations and changes in fund balances for the two fiscal years ended June 30, 2006.
4. Determine the implementation status of prior audit recommendations.

This report contains eight recommendations to the department and one disclosure issue. Other concerns not having a significant effect on the successful operations of the department are not specifically included in this report but have been discussed with management.

In accordance with section 5-13-307, MCA, we analyzed and disclosed the cost, if significant, of implementing the recommendations made in this report.

We evaluated charges for services in the Internal Service Fund as required by section 17-8-101 (6), MCA. We found the charges and fund equity reasonable for the operations in the fund in fiscal years 2004-05 and 2005-06.

Background Information

The Executive Reorganization Act of 1971 established a department to manage the state's natural resources. In 1995, the reorganization of Montana's natural resources and environmental agencies created the current Department of Natural Resources and Conservation. The mission statement of the Montana Department of Natural Resources and Conservation is:

Introduction

“To help ensure Montana’s land and water resources provide benefits for present and future generations.”

The department executes its mission by promoting the stewardship of Montana’s water, soil, forest, and rangeland resources, and regulating forest practices and oil and gas exploration and production.

Department Organization

The State Board of Land Commissioners, comprised of the Governor, State Auditor, Attorney General, Superintendent of Public Instruction, and Secretary of State, exercises the general authority, direction, and control over the care, management, and disposition of state lands under its administration. The department director is the chief administrative officer of the board.

The Reserved Water Rights Compact Commission is attached to the department for administrative purposes. The Reserved Water Rights Compact Commission (9 FTE) was created by the legislature in 1979 as part of the water rights adjudication effort. The commission negotiates water rights with Indian tribes and federal agencies claiming federal reserved water rights within the state in order to establish a formal agreement or compact on the amount of water to be allocated to each interest.

The department’s divisions are described below:

Centralized Services Division (38 FTE) provides management and administrative support services to the department through the Director’s Office and Support Services. The Director’s Office includes the director, legal staff, and public information personnel. Support Services includes fiscal affairs, data processing, personnel, reception, and mail. The division manages all financial activities, coordinates information systems and procurement, produces publications and graphic materials, and performs general administrative support services. Other responsibilities include trust revenue collection and distribution, and maintenance of ownership records for trust and nontrust, state-owned land.

Oil and Gas Conservation Division (21.5 FTE) administers the Montana oil and gas conservation laws. It promotes conservation and prevents waste in the recovery of oil and gas resources through regulation of exploration and production. The division issues drilling permits; classifies wells; establishes well spacing units and pooling orders; inspects drilling, production, and seismic operations; investigates complaints; and does engineering studies. The division also determines incremental production for enhanced recovery and horizontal wells in order to implement the tax incentive program for those projects, operates the underground injection control program, plugs orphan wells, and collects and maintains complete well data and production information. The division provides administrative support to the Board of Oil and Gas Conservation.

Conservation and Resource Development Division (25.5 FTE) is responsible for administering the Conservation District Act, the Montana Rangeland Resources Act and the Natural Streambed and Land Preservation Act. In doing so, the division provides technical, administrative, financial and legal assistance to Montana's 58 conservation districts. The division also manages several loan and grant programs for local communities, local governments, state agencies and private citizens. The programs include State Revolving Fund loans to communities for water and waste water systems, Coal Severance Tax loans to governmental entities, and loans to private entities for water development projects. Loans outstanding exceed \$234 million at June 30, 2006. Grant programs administered by the division include the Reclamation Development, Renewable Resource, and Conservation District grant programs.

Water Resources Division (149.5 FTE) is responsible for programs associated with the use, development, and protection of Montana's water. It manages and maintains the state-owned dams, reservoirs, and canals. The division develops and recommends intrastate, interstate, and international water policy to the director, governor, and legislature. The division also resolves water resource use conflicts, investigates water use violations, ensures dam safety compliance, and provides water adjudication support to the Water

Introduction

Court. The division consists of an administration unit and four bureaus: Water Management Bureau, Water Rights Bureau, State Water Projects Bureau, and the Water Operations Bureau. The 2003 Legislature attached the Flathead Basin Commission to the department for administrative purposes. The commission is charged with protecting the natural resources and environment of the Flathead Basin.

Forestry Division (163.05 FTE) is responsible for planning and implementing forestry programs statewide. The division protects Montana's natural resources from wildfire, regulates forest practices, and provides a variety of services to private forest landowners. The Fire and Aviation Management Program protects 50 million acres of state and private forest and watershed lands from wildfire through a combination of direct protection and county support. The Forest Practice Regulation program enforces Montana's streamside management zone regulations and monitors the voluntary best management practices program on all forests in Montana. In administering Montana's Fire Hazard Reduction Law, the division helps ensure fire hazards created by logging and other forest management operations on private forestlands are adequately reduced, or that additional fire protection is provided until the hazard is reduced. The division provides technical forestry assistance to private landowners, businesses and communities. It also operates the Tree and Shrub Nursery program, which involves growing and selling seedlings for conservation and reforestation plantings on state and private lands in Montana. In fiscal year 2004-05, the division sold 916,377 seedlings, generating gross revenues of \$376,323. In fiscal year 2005-06, 766,130 seedlings were sold for \$379,623.

Trust Land Management Division (125.71 FTE) provides for the administration and management of trust lands granted to the state of Montana by the Enabling Act of 1889. In the process of producing revenue for trust beneficiaries, the division considers environmental factors and protects the future income-generating capacity of the trust lands. These lands currently total over 5.1 million surface acres and 6.2 million mineral acres. Additionally, the division is

responsible for the administration of approximately 6,000 miles of the beds of navigable waterways. The Trust Land Management Division is divided into four primary programs: forest management, agriculture and grazing management, special use management and minerals management.

Prior Audit Recommendations

We performed the prior audit of the department for the two fiscal years ended June 30, 2004. The report contained fifteen recommendations. The department implemented twelve, partially implemented one, and did not implement two of the recommendations.

The recommendation partially implemented relates to funding the Trust Land Administration Account with mineral royalties and other permanent fund revenues. In the prior audit, we recommended the department take immediate measures to resolve the conflict in state law related to the use of Common School Trust mineral royalties and other permanent fund revenues to finance the cost of administering state trust land. At the department's request, the Governor requested an Attorney General's opinion on the matter in September 2005. In a letter dated September 13, 2005, the Attorney General provided legal counsel on the matter, but did not issue an opinion. This counsel does not carry the weight of law or result in a final resolution of the matter, so we recommend the department continue to seek final resolution of the conflict in state law.

The recommendations not implemented addressed timely processing of surface and ground water rights applications and establishing procedures to ensure distributions of unrealized investment income are properly classified on the state's accounting records. These issues are addressed again on pages 19 and 20 of this report.

Findings and Recommendations

Trust Land Administration

The Department of Natural Resources and Conservation (department) administers ten separate land trusts. Of these, nine were established in the federal Enabling and Morrill Acts and Article X of the Montana Constitution. The legislature began using trust revenues to finance the cost of administering these trusts in 1963. From 1963 to 2003, the legislature established seven separate funding sources to pay for various types of administration costs. These include the Forest Improvement, Resource Development, Recreational Use, Timber Sale, Trust Land Administration, and Commercial Leasing Accounts and the State Land Bank Fund. Currently, land trust administration costs are recovered through charges against trust revenues. The Environmental Quality Council Study Subcommittee reviewed and analyzed the methods currently used to finance administration of the land trusts. On July 17, 2006, the subcommittee approved a draft report recommending certain changes be made in the methods used, primarily related to the Morrill Trust.

Under Montana law and generally accepted trust law, the department has a duty of complete loyalty to each individual trust, solely in the interest of that trust's beneficiaries. Section 72-34-110, MCA, indicates the trustee has a duty to keep trust property separate from other property not subject to the trust and to see that trust property is so designated. In Article X, Section 3, the Montana Constitution guarantees the Common School Trust against loss or diversion. The same guarantee exists for the university funds in Article X, Section 10 of the Montana Constitution. In addition, Article X, Section 11 of the Montana Constitution indicates that all public land trusts are to be disposed of for the purposes for which they have been granted.

The following paragraphs discuss instances where the department's method for allocating administration costs violates the trust agreements, its trust duty and state law.

Findings and Recommendations

Morrill Trust Administration Charges

The department violated land trusts through its handling of \$752,543 in Morrill Trust administration charges.

The federal Morrill Act prohibits the department from charging the Morrill Trust for administration costs, requiring the state of Montana to independently fund these costs. Department personnel interpreted the Morrill Act as only prohibiting the department from charging the costs incurred for land sales. The University System questioned this interpretation. In 1996, the attorney general in another state issued an opinion concluding administration costs should not be paid from that state's Morrill Trust revenues. Consequently, the department voluntarily ended its practice of using Morrill Trust revenues to pay administration costs beginning in fiscal year 2002-03.

Fiscal Years 2002-03 Through 2004-05

After the department ended its practice of using Morrill Trust revenues to pay administration costs, it began to deposit revenues from the other land trusts in the Timber Sale, Recreational Use and Trust Land Administration Accounts to cover the charges that would otherwise be allocated to the Morrill Trust. This was the practice until fiscal year 2005-06.

We believe the provisions of the Constitution, when combined with the trust duty established in state law, prohibits the department from using other trust revenues to cover the cost of administering the Morrill Trust. Table 1 outlines the amount of revenues diverted from each of the other trusts during fiscal years 2002-03 through 2004-05.

Findings and Recommendations

Table 1

Land Trust Revenues Diverted For Morrill Trust
Administration Charges
Fiscal Years 2002-03 through 2004-05

<u>Trust</u>	<u>Total</u>
Common School	\$191,945
University of Montana	5
Montana State University – second grant	12,874
Montana Tech	678
State Normal School	5,388
School for the Deaf and Blind	660
State Reform School	7,502
Capitol Building	<u>25,848</u>
Total	<u>\$244,900</u>

Source: Compiled by the Legislative Audit Division from department records.

We believe the department's fiduciary duty obligates it to repay these trusts and their beneficiaries the \$244,900 inappropriately diverted to pay Morrill Trust administration charges, plus accrued interest estimated to be in excess of \$14,000.

Fiscal Years 1966-67 Through 2001-02

Due to the department's initial interpretation of the Morrill Act's requirements, the department deposited Morrill Trust revenues into the Forest Improvement, Resource Development, and Trust Land Administration Accounts during fiscal years 1966-67 through 2001-02. A total of \$507,643 was diverted, by law, from trust revenues during this time period. The department has not repaid the trust or its beneficiary, Montana State University, for the amounts inappropriately withheld. The department's fiduciary duty obligates it to return to the Morrill Trust beneficiary the \$507,643 inappropriately diverted from trust revenues, plus accrued interest estimated to be in excess of \$350,000.

Findings and Recommendations

Available Funding Source

The Timber Sale, Forest Improvement, Resource Development, Recreational Use, and Trust Land Administration Accounts were all established in state law prior to the department's decision to no longer charge the Morrill Trust for administration costs. Contrary to the Morrill Act, these state laws direct the department to deposit certain trust revenues in the Timber Sale, Forest Improvement, Resource Development, Recreational Use, and Trust Land Administration Accounts. In fiscal year 2005-06, the department used General Fund appropriation authority to deposit a combined total of \$14,000 in these accounts on behalf of the Morrill Trust. Because state law specifies these deposits are to come from trust revenues, this practice is contrary to state law. However, the practice results in compliance with the Morrill Act.

The department intends to seek legislation during the 2007 Legislative Session to provide a different funding source for the Morrill Trust administration charges. The department should seek legislation modifying state law to recognize the Morrill Act prohibition on administration costs and to provide a separate funding source for its administration charges.

Recommendation #1

We recommend the department:

- A. Seek legislation to provide a funding source for the administrative costs of the Morrill Trust.**
- B. Seek legislation to exclude the Morrill Trust from administration account deposit requirements.**
- C. Repay the \$507,643 inappropriately withheld from Morrill Trust revenues, plus accrued interest, to the Morrill Trust and its beneficiary, Montana State University.**
- D. Repay the \$244,900 inappropriately withheld from Common School, University of Montana, Montana State University – second grant, Montana Tech, State Normal School, School for the Deaf and Blind, State Reform School, and Capitol Building Trust revenues, plus accrued interest, to the trusts and their beneficiaries.**

Findings and Recommendations

Trust Land Administration Account

Section 77-1-108, MCA, established the Trust Land Administration account effective July 1, 1999. Money in the account is used to pay the costs of administering the land trusts. Account expenditures are limited by a maximum appropriation set in statute. Section 77-1-109, MCA, defines the maximum amount of revenue each land trust can deposit into the account. Department personnel allocate account charges to the land trusts on an annual basis, limiting each trust's deposit to the maximum statutory amount.

Common School Otter Creek Properties

Trust Land Administration Account costs of \$15,406, incurred solely for the benefit of the Common School Trust, were allocated to six other land trusts.

In 2002, the United States Government transferred title to the mineral rights on its Otter Creek properties to the state of Montana. The mineral rights became an asset of the Common School trust. Chapter 318, Laws of 2003, authorized an inventory of related resources to assist in the leasing, promotion, and development of the properties. The department received a \$300,000 appropriation in the Trust Land Administration Account to complete this work. The work was performed in fiscal year 2004-05.

We reviewed the department's fiscal year 2004-05 allocation of Trust Land Administration account charges to the land trusts. We determined the department allocated the Otter Creek inventory costs to six other land trusts in addition to the Common School Trust. We estimate \$15,406 of the costs incurred solely for the benefit of the Common School Trust were improperly allocated to other trusts. Table 2 below shows the amounts by which other trust revenues were diverted for Otter Creek inventory costs.

Findings and Recommendations

Table 2
Land Trust Revenues Diverted For Otter Creek Inventory Costs
Fiscal Year 2004-05

<u>Trust</u>	<u>Amount</u>
University of Montana	\$ 46
Montana State University – second grant	18
Montana Tech	64
State Normal School	409
School for the Deaf and Blind	2,118
Capitol Building	<u>12,751</u>
Total	<u>\$15,406</u>

Source: Compiled by the Legislative Audit Division.

Department personnel stated the administration cost allocation had not previously included costs affecting a single trust, so no procedures for allocating these costs had been developed. We believe the provisions of the Constitution and the department's fiduciary duty to the trusts obligate it to repay \$15,406, plus accrued interest, to the appropriate trusts and their beneficiaries.

Recommendation #2

We recommend the department:

- A. Establish procedures to allocate administration costs affecting a single trust to the affected trust.**
- B. Repay the \$15,406 inappropriately withheld from University of Montana, Montana State University – second grant, Montana Tech, State Normal School, School for the Deaf and Blind, and Capitol Building Trust revenues, plus accrued interest, to these trusts and their beneficiaries.**

Findings and Recommendations

Maximum Deposits

Certain land trust deposits to the Trust Land Administration Account were limited in fiscal years 2004-05 and 2005-06; the Common School Trust paid the difference of \$215,631.

During our review of the department's fiscal year 2004-05 and 2005-06 allocations of Trust Land Administration Account costs to the trusts, we determined portions were inappropriately paid by the Common School Trust. In fiscal year 2004-05, the department allocated costs of \$41,627 to the State Reform School Trust. The maximum amount this trust could deposit into the Trust Land Administration Account, however, was limited by law to \$29,715. The remaining amount of \$11,912 was paid by the Common School Trust. In fiscal year 2005-06, the department initially allocated \$237,666 to the Capitol Building Trust and \$79,564 to the Montana Tech Trust. The maximum deposit amount for the Capitol Building Trust was \$62,659 and the Montana Tech Trust was \$50,852. The combined remaining amount of \$203,719 was paid by the Common School Trust.

We believe the Constitution prohibits charging these costs to the Common School Trust. The Common School Trust was violated so the department could fully fund its Trust Land Administration Account. Section 77-1-109, MCA, does not provide a mechanism for funding the Trust Land Administration Account when cost allocations exceed the maximum deposit amounts allowed by law. The provisions of the Constitution and the department's fiduciary duty to the trust obligate it to repay the \$215,631 inappropriately withheld from Common School Trust revenues, plus accrued interest, to the Common School Trust and its beneficiaries.

Recommendation #3

We recommend the department:

- A. Seek legislation to establish a mechanism for funding the Trust Land Administration Account when initial allocations exceed maximum deposit amounts.**
- B. Repay the \$215,631 inappropriately withheld from Common School Trust revenues, plus accrued interest, to the Common School Trust and its beneficiaries.**

Findings and Recommendations

Trust Administration Costs

Trust administration costs are allocated based on trust revenues; the actual cost of administering each trust is unknown.

Under Montana law and generally accepted trust law, the department has a duty of complete loyalty to each trust, solely in the interest of the beneficiaries. In a letter dated September 13, 2005, the Attorney General indicated that in the absence of a specific restriction, the department, as trustee, has a right to reimbursement for expenses incurred in administering each trust. Administrative costs are required to be reasonable, incurred in perpetuating the purpose of the trust and not for other unrelated matters.

Administration costs are charged or allocated to the land trusts based on trust revenues, a practice established through department policy. The following summarizes how certain administration account costs are charged or allocated to the land trusts:

- ▶ The Forest Improvement Account receives fees assessed against successful timber contract bidders.
- ▶ The Resource Development Account receives a portion of each trust's income, currently set at 3 percent.
- ▶ The Recreational Use Account receives a portion of recreational use license fees.
- ▶ The Timber Sale Account receives a portion of timber sale revenues, up to the appropriation for the account.
- ▶ The Trust Land Administration Account receives deposits of certain trust income; the maximum deposit is 10 percent of certain Capitol Building Trust revenues and 1.125 percent of the book value of each of the remaining trusts.
- ▶ The Commercial Leasing Account receives up to 10 percent of commercial lease revenues.

Department expenditure records are not maintained in sufficient detail to identify the costs incurred for the benefit of each trust. Department records only show the total cost of administering all of the land trusts combined or the costs associated with each type of land use, such as agricultural or mineral leases. The department could not provide documentation to support their assertion that the administration charges authorized by state law are a reasonable

Findings and Recommendations

representation of the actual costs incurred in administering each land trust. The department currently is unable to demonstrate that the costs incurred in the Forest Improvement, Resource Development, Recreational Use, Timber Sale, Trust Land Administration and Commercial Leasing accounts are reasonable costs incurred in perpetuating the purpose of each trust and not for other unrelated matters.

We believe the department should maintain its expenditure records in sufficient detail to identify the costs incurred for the benefit of each trust. This will allow the department to demonstrate the administrative charges to each trust are reasonable. If the data demonstrates the charges are not reasonable, then the department should develop a revised allocation method that will result in reasonable charges to each trust.

The department should also continue to maintain its expenditure records by type of land use. State law requires the department to administer the land trusts in a manner that maximizes revenues. Maintaining expenditure data by trust and land use will allow the department to better determine if current land uses maximize trust revenues or if alternative uses would generate more net revenue.

Department personnel stated that maintaining expenditure data by land trust will always involve the allocation of certain costs that benefit multiple trusts. Techniques are available to the department for obtaining reasonable estimates of the benefit these costs provide to each trust without creating an undue administrative burden. These include, but are not limited to, the use of random moment time studies, charging certain personal services costs to individual trusts based on actual time spent, allocating certain personal services costs based on the number of related accounting transactions processed for each trust or other similar events, or by allocating costs based on the average costs of certain services performed by department personnel. In determining the most appropriate methods to use, the cost and benefit of each method should be considered.

Findings and Recommendations

Recommendation #4

We recommend the department:

- A. Maintain expenditure records in sufficient detail to identify the administration costs incurred for the benefit of each trust, and**
- B. Evaluate the expenditure data to ensure each land trust's administration charges are reasonable and, if necessary, develop another allocation method that results in reasonable charges.**

Trust Land Administration Summary

Diverting individual trust revenues for the benefit of other trusts does not perpetuate the purpose of each trust, placing the department at risk.

Using trust revenue to fund administration cost may not be justified when the risks and costs associated with this system are fully considered. As addressed previously, the manner in which the department used trust revenues to fund administration costs violated land trusts, resulting in recommendations to repay amounts inappropriately withheld from trust revenues. We believe that continuing these practices will result in continued trust violations and noncompliance with state law, placing the department at risk for litigation and resulting in the need for additional repayments.

Before the Timber Sale, Forest Improvement, Resource Development, Recreational Use, and Trust Land Administration Accounts were established in state law, administration costs were paid from the General Fund. If the department had continued using General Fund appropriation authority rather than trust revenue to pay administration costs, the trust violations summarized in Table 3 below would not have occurred. When estimated accrued interest is included, the combined amount necessary to repay the trusts and their beneficiaries exceeds \$1.3 million.

Findings and Recommendations

Table 3
Summary of Amounts Inappropriately Withheld From Trust Revenues¹

<u>Trust</u>	<u>Recommendation</u>				<u>Total</u>
	<u>#1C</u>	<u>#1D</u>	<u>#2</u>	<u>#3</u>	
Common School		\$191,945		\$215,631	\$407,576
University of Montana		5	\$ 46		51
Morrill Trust	\$507,643				507,643
Montana State University – second grant		12,874	18		12,892
Montana Tech		678	64		742
State Normal School		5,388	409		5,797
School for the Deaf and Blind		660	2,118		2,778
State Reform School		7,502			7,502
Capitol Building		25,848	12,751		38,599
Total	<u>\$507,643</u>	<u>\$244,900</u>	<u>\$15,406</u>	<u>\$215,631</u>	<u>\$983,580</u>

¹ Amounts do not include related estimated accrued interest.

Source: Compiled by the Legislative Audit Division from department records.

Most of the revenues inappropriately deposited into the Trust Land Administration Account would have otherwise been added to trust investments, ultimately increasing the revenues available for distribution to beneficiaries. In the case of the Common School Trust, while the provisions of Chapter 418, Laws of 2001, are in effect, increased distributions reduce the amount of General Fund money needed for school equalization payments. Prior to July 1, 2001, and after repayment of the coal tax loan used to purchase the mineral royalty income stream, the revenues would otherwise be added to trust investments.

The revenues from the State Reform School and School for the Deaf and Blind Trusts inappropriately deposited into the Timber Sale and Forest Improvement Accounts would have otherwise been added to the trusts, increasing investments and the related revenue distributed to the schools. The remaining revenues inappropriately deposited in the Resource Development, Recreational Use, Timber Sale and Forest Improvement Accounts would have been distributed to the trust beneficiaries.

Findings and Recommendations

Any increases in the distributions to beneficiaries potentially limit the need for General Fund or other support provided to the beneficiaries. We believe that in time, the cost of using a money source other than trust revenues to fund trust administration costs will be offset by a reduction in General Fund or other support provided to the beneficiaries and mitigate the risks associated with future trust violations.

Recommendation #5

We recommend the department discontinue diverting revenues of one trust to pay administrative costs allocated to other trusts.

Appropriation and Compliance Issues

During the audit period, the department did not comply with certain state laws, including appropriation law, applicable to its operations. The following sections describe instances where compliance with state law can be improved.

Improper Use of Appropriations

The department charged regular employee salaries to an appropriation provided for seasonal fire fighter pay exceptions.

The 2005 Legislature appropriated \$66,000 from the State Special Revenue Fund in fiscal year 2004-05 for seasonal fire fighter pay exceptions. We determined that of the \$62,932 charged to this appropriation, \$23,522 was for regular employee pay, rather than seasonal fire fighter pay. Department personnel indicated they were using this appropriation to cover shortfalls in some of its fire cost accounting centers. Although these costs were valid expenses of the department, they were not related to seasonal fire fighter pay and should not have been charged to the appropriation. The appropriations that should have been charged were not fully spent. After we informed them of our concerns, department personnel processed correcting entries on the primary accounting system.

Recommendation #6

We recommend the department limit charges to its appropriations to purposes specified in appropriation laws.

Findings and Recommendations

Surface and Ground Water Rights

The department is not processing surface and ground water rights applications in a timely manner.

Sections 85-2-309 and 85-2-310, MCA, provide for an application process to establish surface and ground water rights. When the department receives an objection to an application, it is required to hold a contested case hearing within 60 days. It must also grant, deny, or condition the application within 180 days of its last publication of notice of application. If no objections are received, the department has 120 days to finalize the application. During our prior audit, we noted several instances where applications were not finalized in a timely manner. During this audit, we reviewed the current status of water rights applications and determined similar issues exist in fiscal years 2004-05 and 2005-06. We noted 37 applications, requiring no hearing, were finalized between 212 and 627 days after the date of receipt. We also noted one application, requiring a hearing, that was finalized 359 days after initial receipt and 308 days after the publication of notice of application. The processing deadlines in state law commit to the public that applications will be processed in a timely manner.

Department personnel indicated they have difficulty meeting the application processing deadlines established in state law due to the volume of objections received and the need to gather additional information from the applicant. According to department personnel, they have hired two employees and are in the process of hiring a third individual to assist with application processing. Department personnel estimate they were 18 months behind in processing applications two years ago, but are only 10 months behind now.

Recommendation #7

We recommend the department process surface and ground water rights applications in the timeframes required by state law.

Findings and Recommendations

Recording Unrealized Investment Losses

Errors in Permanent Fund revenues and expenditures contributed to the Independent Auditor's Report qualification.

Section 17-1-102, MCA, requires each agency to record the transactions necessary to ensure the state's accounting records present the receipt, use, and disposition of all property for which it is accountable in accordance with generally accepted accounting principles by fiscal year-end. Annually, department personnel distribute unrealized investment gains or losses to each of its permanent funds. In fiscal year 2005-06, department personnel incorrectly distributed unrealized investment losses to the permanent funds as gains. As a result, Permanent Fund revenues and expenditures are overstated by \$23,601,751 in fiscal year 2005-06. This issue contributed to the Independent Auditor's Report qualification described on page A-3.

Department personnel notified us of the error, which they identified when reviewing financial reports after the close of the fiscal year-end period. A final review of financial reports generated just prior to the close of the fiscal year-end period would have allowed department personnel to identify and correct this error as fiscal year 2005-06 financial transactions, rather than in the subsequent fiscal year.

Recommendation #8

We recommend the department comply with section 17-1-102, MCA, by establishing procedures to ensure distributions of unrealized investment losses are properly classified on the state's accounting records.

Capitol Building Trust

State law prescribes a different basis for determining the maximum appropriation and deposit amounts related to the Capitol Building Trust, potentially resulting in an inequitable allocation of costs.

In accordance with section 77-1-108, MCA, the department calculates the portion of the Trust Land Administration Account's maximum appropriation attributable to the Capitol Building Trust using 10 percent of certain trust revenues. Section 77-1-109, MCA, requires the Capitol Building Trust maximum deposit also be calculated using a percentage of trust revenues. Book value is the basis for the maximum appropriation and deposit amounts applicable to the other trusts. Department personnel stated the different basis is related to how the Capitol Building Trust was initially established; all Capitol Building Trust revenues are distributed to the beneficiary, so none of the revenues are used to establish an invested corpus.

We analyzed the impact these provisions have on the Capitol Building Trust. We determined the Capitol Building Trust deposits a larger percentage of its total revenue into the Trust Land Administration Account than the other land trusts. The Capitol Building Trust deposited 14.10 and 3.01 percent of its total revenues into the Trust Land Administration Account in fiscal years 2004-05 and 2005-06, respectively. The other trusts deposited up to 5.82 percent of their total revenues in the account in fiscal year 2004-05 and up to 4.21 percent in fiscal year 2005-06.

By maintaining expenditure records in sufficient detail to identify the costs incurred for the benefit of each trust, as we recommend on page 16, the department can determine if the basis used for the Capitol Building Trust's maximum deposit results in an inequitable allocation of costs. As such, we make no further recommendation at this time.

Independent Auditor's Report & Department Financial Schedules

LEGISLATIVE AUDIT DIVISION

Scott A. Seacat, Legislative Auditor
Tori Hunthausen,
Chief Deputy Legislative Auditor



Deputy Legislative Auditors:
James Gillett
Jim Pellegrini

INDEPENDENT AUDITOR'S REPORT

The Legislative Audit Committee
of the Montana State Legislature:

We have audited the accompanying Schedules of Changes in Fund Balances & Property Held in Trust, Schedules of Total Revenues & Transfers-In, and Schedules of Total Expenditures & Transfers-Out of the Department of Natural Resources and Conservation for each of the fiscal years ended June 30, 2006, and 2005. The information contained in these financial schedules is the responsibility of the department's management. Our responsibility is to express an opinion on these financial schedules based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial schedules are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial schedules. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial schedule presentation. We believe that our audit provides a reasonable basis for our opinion.

As described in note 1, the financial schedules are presented on a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America. The schedules are not intended to be a complete presentation and disclosure of the department's assets, liabilities and cash flows.

The department made errors in recording expenditures and revenues in the Permanent Fund in fiscal year 2005-06 related to the distribution of unrealized investment losses. Nonbudgeted Revenues & Transfers-In and Nonbudgeted Expenditures & Transfers-Out are overstated by \$23,601,751 on the Schedule of Changes in Fund Balances & Property Held in Trust. Other Financing Sources are overstated by \$23,601,751 on the Schedule of Total Revenues & Transfers-In and Accounting Entity Transfers are overstated by \$23,601,751 on the Schedule of Total Expenditures & Transfers-Out.

In our opinion, except for the effects of the errors in recording revenues and expenditures as discussed in the preceding paragraph, the financial schedules referred to above present fairly, in all material respects, the results of operations and changes in fund balances and property held in trust of the Department of Natural Resources and Conservation for each of the fiscal years ended June 30, 2006, and 2005, in conformity with the basis of accounting described in note 1.

Respectfully submitted,

/s/ James Gillett

James Gillett, CPA

Deputy Legislative Auditor

August 16, 2006

DEPARTMENT OF NATURAL RESOURCES & CONSERVATION
SCHEDULE OF CHANGES IN FUND BALANCES & PROPERTY HELD IN TRUST
FOR THE FISCAL YEAR ENDED JUNE 30, 2006

	General Fund	State Special Revenue Fund	Federal Special Revenue Fund	Debt Service Fund	Enterprise Fund	Internal Service Fund	Agency Fund	Permanent Fund
FUND BALANCE: July 1, 2005	\$ (3,179,185)	\$ 195,038,642	\$ (180,913)	\$ 40,361,143	\$ 0	\$ 86,307	\$ 0	\$ 446,216,724
PROPERTY HELD IN TRUST: July 1, 2005							\$ 2,637,918	
ADDITIONS								
Budgeted Revenues & Transfers-In	203,950	108,480,359	8,707,645		388,942	1,613,517		
Nonbudgeted Revenues & Transfers-In	80,749	75,727,574	0	15,991,556	17,219	593		104,310,799
Prior Year Revenues & Transfers-In Adjustments	(5,343,463)	(335,418)	(166,972)	286,098		1,484		19,814
Direct Entries to Fund Balance	30,671,327	(47,061,238)	338,678	333,874	45	13,784		39,728
Additions to Property Held in Trust							1,895,596	
Total Additions	<u>25,612,563</u>	<u>136,811,277</u>	<u>8,879,351</u>	<u>16,611,528</u>	<u>406,206</u>	<u>1,629,378</u>	<u>1,895,596</u>	<u>104,370,341</u>
REDUCTIONS								
Budgeted Expenditures & Transfers-Out	25,227,222	24,997,224	8,667,812		387,027	1,525,116		
Nonbudgeted Expenditures & Transfers-Out	115,475	61,158,797	3,514	20,325,450	32,160	9,822		122,542,285
Prior Year Expenditures & Transfers-Out Adjustments	2,036	(357,314)	(15,627)	(216,557)		5,656		(28,774)
Reductions in Property Held in Trust							2,150,576	
Total Reductions	<u>25,344,733</u>	<u>85,798,707</u>	<u>8,655,699</u>	<u>20,108,893</u>	<u>419,187</u>	<u>1,540,594</u>	<u>2,150,576</u>	<u>122,513,511</u>
FUND BALANCE: June 30, 2006	\$ (2,911,355)	\$ 246,051,212	\$ 42,739	\$ 36,863,778	\$ (12,981)	\$ 175,091	\$ 0	\$ 428,073,554
PROPERTY HELD IN TRUST: June 30, 2006							\$ 2,382,938	

This schedule is prepared from the Statewide Accounting, Budgeting, and Human Resources System (SABHRS) without adjustment. Additional information is provided in the notes to the financial schedules beginning on page A-11.

DEPARTMENT OF NATURAL RESOURCES AND CONSERVATION
SCHEDULE OF CHANGES IN FUND BALANCES & PROPERTY HELD IN TRUST
FOR THE FISCAL YEAR ENDED JUNE 30, 2005

	<u>General Fund</u>	<u>State Special Revenue Fund</u>	<u>Federal Special Revenue Fund</u>	<u>Debt Service Fund</u>	<u>Internal Service Fund</u>	<u>Agency Fund</u>	<u>Permanent Fund</u>
FUND BALANCE: July 1, 2004	\$ <u>(1,674,973)</u>	\$ <u>178,616,779</u>	\$ <u>(15,460,443)</u>	\$ <u>43,403,919</u>	\$ <u>99,027</u>	\$ <u>0</u>	\$ <u>436,709,062</u>
PROPERTY HELD IN TRUST: July 1, 2004						\$ <u>2,109,945</u>	
ADDITIONS							
Budgeted Revenues & Transfers-In	5,550,661	122,849,139	7,086,604		924,875		
Nonbudgeted Revenues & Transfers-In	93,908	42,547,631	1,255	34,616,264	320		125,352,298
Prior Year Revenues & Transfers-In Adjustments	15,102	(1,013,931)	(18,545,107)	662,656			461,154
Direct Entries to Fund Balance	26,698,441	(53,656,370)	36,819,841	410,821			54,287
Additions to Property Held in Trust						2,044,710	
Total Additions	<u>32,358,112</u>	<u>110,726,469</u>	<u>25,362,592</u>	<u>35,689,741</u>	<u>925,195</u>	<u>2,044,710</u>	<u>125,867,739</u>
REDUCTIONS							
Budgeted Expenditures & Transfers-Out	28,290,376	26,908,959	10,039,371		923,584		
Nonbudgeted Expenditures & Transfers-Out	(12,686)	66,905,628	26,255	38,718,624	14,519		116,415,405
Prior Year Expenditures & Transfers-Out Adjustments	5,584,634	490,019	17,436	13,893	(188)		(55,328)
Reductions in Property Held in Trust						1,516,737	
Total Reductions	<u>33,862,324</u>	<u>94,304,606</u>	<u>10,083,062</u>	<u>38,732,517</u>	<u>937,916</u>	<u>1,516,737</u>	<u>116,360,077</u>
FUND BALANCE: June 30, 2005	\$ <u><u>(3,179,185)</u></u>	\$ <u><u>195,038,642</u></u>	\$ <u><u>(180,913)</u></u>	\$ <u><u>40,361,143</u></u>	\$ <u><u>86,307</u></u>	\$ <u><u>0</u></u>	\$ <u><u>446,216,724</u></u>
PROPERTY HELD IN TRUST: June 30, 2005						\$ <u><u>2,637,918</u></u>	

This schedule is prepared from the Statewide Accounting, Budgeting, and Human Resources System (SABHRS) without adjustment. Additional information is provided in the notes to the financial schedules beginning on page A-11.

DEPARTMENT OF NATURAL RESOURCE & CONSERVATION
SCHEDULE OF TOTAL REVENUES & TRANSFERS-IN
FOR THE FISCAL YEAR ENDED JUNE 30, 2006

	General Fund	State Special Revenue Fund	Federal Special Revenue Fund	Debt Service Fund	Enterprise Fund	Internal Service Fund	Permanent Fund	Total
TOTAL REVENUES & TRANSFERS-IN BY CLASS								
Licenses and Permits	\$ 1,655	\$ 290,431					\$ 176,119	\$ 468,205
Taxes	5,533	2,448,162			\$ 29	\$ 593		2,454,317
Charges for Services	(5,258,679)	6,650,479		\$ 1,659	2,200	605,580		2,001,239
Investment Earnings	133,187	2,810,787		7,908,406			2,749,568	13,601,948
Fines, Forfeits and Settlements	6,105	48,383						54,488
Sale of Documents, Merchandise and Property	27,664	519,869		2,799,889	379,623		14,068,632	17,795,677
Rentals, Leases and Royalties	22,633	487,427					62,152,897	62,662,957
Miscellaneous	3,138	8,448						11,586
Grants, Contracts, Donations and Abandonments		1,571,102						1,571,102
Other Financing Sources		169,037,709		5,567,700	17,190	1,009,421	25,183,397	200,815,417
Federal		(282)	\$ 8,392,400					8,392,118
Federal Indirect Cost Recoveries			148,273					148,273
Capital Contributions					7,119			7,119
Total Revenues & Transfers-In	(5,058,764)	183,872,515	8,540,673	16,277,654	406,161	1,615,594	104,330,613	309,984,446
Less: Nonbudgeted Revenues & Transfers-In	80,749	75,727,574		15,991,556	17,219	593	104,310,799	196,128,490
Prior Year Revenues & Transfers-In Adjustments	(5,343,463)	(335,418)	(166,972)	286,098		1,484	19,814	(5,538,457)
Actual Budgeted Revenues & Transfers-In	203,950	108,480,359	8,707,645	0	388,942	1,613,517	0	119,394,413
Estimated Revenues & Transfers-In	221,889	109,241,817	8,353,024		384,400	1,615,250		119,816,380
Budgeted Revenues & Transfers-In Over (Under) Estimated	\$ (17,939)	\$ (761,458)	\$ 354,621	\$ 0	\$ 4,542	\$ (1,733)	\$ 0	\$ (421,967)

BUDGETED REVENUES & TRANSFERS-IN OVER (UNDER) ESTIMATED BY CLASS

Licenses and Permits		\$ (4,169)						\$ (4,169)
Taxes	\$ (11,832)	(33,209)	\$ (25)			\$ (250)		(45,316)
Charges for Services	(4,395)	(28,925)				(904)		(34,224)
Investment Earnings		40,255	(750)					39,505
Fines, Forfeits and Settlements	(12)	(17)						(29)
Sale of Documents, Merchandise and Property		9,869			\$ 4,623			14,492
Rentals, Leases and Royalties	(756)	(5,844)						(6,600)
Miscellaneous	(944)	(54)						(998)
Grants, Contracts, Donations and Abandonments		(35,420)						(35,420)
Other Financing Sources		(703,944)				(579)		(704,523)
Federal			356,732					356,732
Federal Indirect Cost Recoveries			(1,336)					(1,336)
Capital Contributions				\$	(81)		\$	(81)
Budgeted Revenues & Transfers-In Over (Under) Estimated	\$ (17,939)	\$ (761,458)	\$ 354,621	\$ 0	\$ 4,542	\$ (1,733)	\$ 0	\$ (421,967)

This schedule is prepared from the Statewide Accounting, Budgeting, and Human Resources System (SABHRS) without adjustment.
Additional information is provided in the notes to the financial schedules beginning on page A-11.

DEPARTMENT OF NATURAL RESOURCES AND CONSERVATION
SCHEDULE OF TOTAL REVENUES & TRANSFERS-IN
FOR THE FISCAL YEAR ENDED JUNE 30, 2005

	General Fund	State Special Revenue Fund	Federal Special Revenue Fund	Debt Service Fund	Internal Service Fund	Permanent Fund	Total
TOTAL REVENUES & TRANSFERS-IN BY CLASS							
Licenses and Permits	\$ 2,126	\$ 287,716				\$ 188,498	\$ 478,340
Taxes	3,053	2,516,328	\$ 1,255		\$ 319		2,520,955
Charges for Services	5,690,007	4,719,165	(31,749,747)	\$ 28,060	339,171	800	(20,972,544)
Investment Earnings	(133,187)	117,120	40	7,696,698		34,450,387	42,131,058
Fines, Forfeits and Settlements	11,100	30,878					41,978
Sale of Documents, Merchandise and Property	69,027	935,305		2,622,868		14,704,820	18,332,020
Rentals, Leases and Royalties	15,661	520,562				42,426,943	42,963,166
Miscellaneous	1,884	24,548					26,432
Grants, Contracts, Donations and Abandonments		897,022	3,484				900,506
Other Financing Sources		154,334,195		24,931,294	585,705	34,042,004	213,893,198
Federal			20,166,723				20,166,723
Federal Indirect Cost Recoveries			120,997				120,997
Total Revenues & Transfers-In	5,659,671	164,382,839	(11,457,248)	35,278,920	925,195	125,813,452	320,602,829
Less: Nonbudgeted Revenues & Transfers-In	93,908	42,547,631	1,255	34,616,264	320	125,352,298	202,611,676
Prior Year Revenues & Transfers-In Adjustments	15,102	(1,013,931)	(18,545,107)	662,656		461,154	(18,420,126)
Actual Budgeted Revenues & Transfers-In	5,550,661	122,849,139	7,086,604	0	924,875	0	136,411,279
Estimated Revenues & Transfers-In	121,210	134,486,943	11,474,931		860,000		146,943,084
Budgeted Revenues & Transfers-In Over (Under) Estimated	\$ 5,429,451	\$ (11,637,804)	\$ (4,388,327)	\$ 0	\$ 64,875	\$ 0	\$ (10,531,805)

BUDGETED REVENUES & TRANSFERS-IN OVER (UNDER) ESTIMATED BY CLASS

Licenses and Permits		\$ 71,066					\$ 71,066
Taxes		(546)					(546)
Charges for Services	\$ 5,560,004	1,503,127			\$ (120,829)		6,942,302
Investment Earnings	(133,187)	(1,717,698)	\$ (2,715)				(1,853,600)
Fines, Forfeits and Settlements	1,960	(14,122)					(12,162)
Sale of Documents, Merchandise and Property		(3,049,617)					(3,049,617)
Rentals, Leases and Royalties	(175)	(13,538)					(13,713)
Miscellaneous	849	(4,954)					(4,105)
Grants, Contracts, Donations and Abandonments		343,604	3,484				347,088
Other Financing Sources		(8,755,126)			185,704		(8,569,422)
Federal			(4,380,127)				(4,380,127)
Federal Indirect Cost Recoveries			(8,969)				(8,969)
Budgeted Revenues & Transfers-In Over (Under) Estimated	\$ 5,429,451	\$ (11,637,804)	\$ (4,388,327)	\$ 0	\$ 64,875	\$ 0	\$ (10,531,805)

This schedule is prepared from the Statewide Accounting, Budgeting, and Human Resources System (SABHRS) without adjustment.
Additional information is provided in the notes to the financial schedules beginning on page A-11.

DEPARTMENT OF NATURAL RESOURCE & CONSERVATION
SCHEDULE OF TOTAL EXPENDITURES & TRANSFERS-OUT
FOR THE FISCAL YEAR ENDED JUNE 30, 2006

PROGRAM (ORG) EXPENDITURES & TRANSFERS-OUT	Centralized Services	Conservation & Resource Development Division	Forestry & Trust Lands	Oil & Gas Conservation Division	Reserved Water Rights Compact Commission	Trust Funds	Water Resources Division	Total
Personal Services								
Salaries	\$ 1,536,258	\$ 992,356	\$ 10,745,461	\$ 727,506	\$ 457,080		\$ 5,633,141	\$ 20,091,802
Hourly Wages			3,198,060				660	3,198,720
Other Compensation		700		7,800	5,333		350	14,183
Employee Benefits	438,284	289,341	3,885,618	221,221	124,347		1,740,579	6,699,390
Personal Services-Other			12,648					12,648
Total	<u>1,974,542</u>	<u>1,282,397</u>	<u>17,841,787</u>	<u>956,527</u>	<u>586,760</u>		<u>7,374,730</u>	<u>30,016,743</u>
Operating Expenses								
Other Services	267,210	1,131,800	6,251,922	259,204	87,041		3,784,263	11,781,440
Supplies & Materials	50,184	93,043	2,135,788	53,690	14,624		392,674	2,740,003
Communications	47,279	43,179	361,437	49,987	9,645		291,519	803,046
Travel	27,104	89,899	514,688	41,512	26,042		143,611	842,856
Rent	186,582	70,538	2,548,967	24,897	38,431		593,601	3,463,016
Utilities	20,525	5,444	210,008	14,612	4,659		8,736	263,984
Repair & Maintenance	4,656	7,352	899,303	22,082	1,856		89,236	1,024,485
Other Expenses	20,826	36,349	607,744	27,587	3,766		320,530	1,016,802
Goods Purchased For Resale			5,451					5,451
Total	<u>624,366</u>	<u>1,477,604</u>	<u>13,535,308</u>	<u>493,571</u>	<u>186,064</u>		<u>5,624,170</u>	<u>21,941,083</u>
Equipment & Intangible Assets								
Equipment	20,639	54,995	1,133,790	48,345			31,921	1,289,690
Intangible Assets							14,700	14,700
Total	<u>20,639</u>	<u>54,995</u>	<u>1,133,790</u>	<u>48,345</u>			<u>46,621</u>	<u>1,304,390</u>
Capital Outlay								
Land & Interest In Land			118,347				3,000	121,347
Total			<u>118,347</u>				<u>3,000</u>	<u>121,347</u>
Local Assistance								
Grants								
From State Sources		3,046,832						3,046,832
From Federal Sources			2,657,708					2,657,708
Total		<u>3,046,832</u>	<u>2,657,708</u>					<u>5,704,540</u>
Transfers								
Accounting Entity Transfers		66,353,446	3,422,904			\$ 118,746,033	603,514	189,125,897
Intra-Entity Expense			48,171			3,767,478		3,815,649
Total		<u>66,353,446</u>	<u>3,471,075</u>			<u>122,513,511</u>	<u>603,514</u>	<u>192,941,546</u>
Debt Service								
Bonds		11,966,637						11,966,637
Loans			185				377,584	377,769
Capital Leases	2,315		4,954					7,269
Total	<u>2,315</u>	<u>11,966,637</u>	<u>5,139</u>				<u>377,584</u>	<u>12,351,675</u>
Total Expenditures & Transfers-Out	\$ <u>2,621,862</u>	\$ <u>84,181,911</u>	\$ <u>38,763,154</u>	\$ <u>1,498,443</u>	\$ <u>772,824</u>	\$ <u>122,513,511</u>	\$ <u>14,029,619</u>	\$ <u>264,381,324</u>
EXPENDITURES & TRANSFERS-OUT BY FUND								
General Fund	\$ 1,983,149	\$ 1,294,084	\$ 14,020,711		\$ 772,824		\$ 7,273,965	\$ 25,344,733
State Special Revenue Fund	485,143	62,452,990	15,684,026	\$ 1,352,735			5,823,813	85,798,707
Federal Special Revenue Fund	153,570	331,797	7,098,636	145,708			925,988	8,655,699
Debt Service Fund		20,103,040					5,853	20,108,893
Enterprise Fund			419,187					419,187
Internal Service Fund			1,540,594					1,540,594
Permanent Fund						\$ 122,513,511		122,513,511
Total Expenditures & Transfers-Out	2,621,862	84,181,911	38,763,154	1,498,443	772,824	122,513,511	14,029,619	264,381,324
Less: Nonbudgeted Expenditures & Transfers-Out		78,676,111	2,804,317			122,542,285	164,790	204,187,504
Prior Year Expenditures & Transfers-Out Adjustments	(16,183)	(470,801)	(46,716)	4,377	(186)	(28,774)	(52,297)	(610,580)
Actual Budgeted Expenditures & Transfers-Out	2,638,045	5,976,601	360,055,543	1,494,066	773,010	0	13,917,126	60,804,401
Budget Authority	2,737,459	20,809,018	43,542,971	3,708,258	803,024		17,311,077	88,911,807
Unspent Budget Authority	\$ <u>99,414</u>	\$ <u>14,832,417</u>	\$ <u>7,537,418</u>	\$ <u>2,214,192</u>	\$ <u>30,014</u>	\$ <u>0</u>	\$ <u>3,393,951</u>	\$ <u>28,107,406</u>
UNSPENT BUDGET AUTHORITY BY FUND								
General Fund	\$ 69,426	\$ 79	\$ 58,271		\$ 30,014		\$ 89,485	\$ 247,275
State Special Revenue Fund	29,988	14,811,867	354,887	\$ 1,499,663			2,290,227	18,986,632
Federal Special Revenue Fund		20,471	6,941,365	714,529			1,014,239	8,690,604
Enterprise Fund			71,493					71,493
Internal Service Fund			111,402					111,402
Unspent Budget Authority	\$ <u>99,414</u>	\$ <u>14,832,417</u>	\$ <u>7,537,418</u>	\$ <u>2,214,192</u>	\$ <u>30,014</u>	\$ <u>0</u>	\$ <u>3,393,951</u>	\$ <u>28,107,406</u>

This schedule is prepared from the Statewide Accounting, Budgeting, and Human Resources System (SABHRS) without adjustment. Additional information is provided in the notes to the financial schedules beginning on page A-11.

DEPARTMENT OF NATURAL RESOURCE AND CONSERVATION
SCHEDULE OF TOTAL EXPENDITURES & TRANSFERS-OUT
FOR THE FISCAL YEAR ENDED JUNE 30, 2005

PROGRAM (ORG) EXPENDITURES & TRANSFERS-OUT	Centralized Services	Conservation Resource Development Division	Forestry and Trust Lands	Oil & Gas Conservation Division	Reserved Water Rights Compact Commission	Water Resources Division	Total
Personal Services							
Salaries	\$ 1,477,099	\$ 902,992	\$ 9,329,129	\$ 672,140	\$ 427,195	\$ 4,451,294	\$ 17,259,849
Hourly Wages	6,500		2,170,566				2,177,066
Other Compensation		1,135	101	6,550	4,535	100	12,421
Employee Benefits	403,440	267,257	3,354,570	203,788	118,079	1,338,565	5,685,698
Personal Services-Other		19,059					19,059
Total	<u>1,887,039</u>	<u>1,171,384</u>	<u>14,873,425</u>	<u>882,477</u>	<u>549,809</u>	<u>5,789,959</u>	<u>25,154,093</u>
Operating Expenses							
Other Services	348,287	1,106,037	12,333,479	853,428	34,666	1,863,517	16,539,414
Supplies & Materials	62,876	45,125	1,493,854	34,231	15,360	261,422	1,912,868
Communications	39,102	34,064	333,360	46,230	7,886	135,750	596,392
Travel	23,309	67,744	324,164	37,361	17,602	112,478	582,658
Rent	217,816	62,802	1,386,352	16,959	39,978	451,037	2,174,944
Utilities	13,129	4,206	174,300	13,013	4,209	8,047	216,904
Repair & Maintenance	(1,460)	6,470	832,492	18,320	2,219	51,264	909,305
Other Expenses	43,277	385,553	584,350	19,401	5,281	91,770	1,129,632
Goods Purchased For Resale		4,555					4,555
Total	<u>746,336</u>	<u>1,712,001</u>	<u>17,466,906</u>	<u>1,038,943</u>	<u>127,201</u>	<u>2,975,285</u>	<u>24,066,672</u>
Equipment & Intangible Assets							
Equipment	15,371		695,946	19,927		7,585	738,829
Capital Leases-Equipment-Nonbu			1,832				1,832
Total	<u>15,371</u>		<u>697,778</u>	<u>19,927</u>		<u>7,585</u>	<u>740,661</u>
Local Assistance							
From State Sources		212,810					212,810
Total		<u>212,810</u>					<u>212,810</u>
Grants							
From State Sources		7,867,603					7,867,603
From Federal Sources		10,000	3,087,165				3,097,165
Total		<u>7,877,603</u>	<u>3,087,165</u>				<u>10,964,768</u>
Benefits & Claims							
From State Sources		10,000,000					10,000,000
Other Financing Uses/Deduction		4,997,617					4,997,617
Total		<u>14,997,617</u>					<u>14,997,617</u>
Transfers							
Accounting Entity Transfers	37,366	85,234,741	115,479,171			2,571	200,753,849
Intra-Entity Expense			4,494,314				4,494,314
Total	<u>37,366</u>	<u>85,234,741</u>	<u>119,973,485</u>			<u>2,571</u>	<u>205,248,163</u>
Debt Service							
Bonds		12,468,731					12,468,731
Loans		9,915	5,529			395,082	410,526
Capital Leases	2,830		13,630				16,460
Total	<u>2,830</u>	<u>12,478,646</u>	<u>19,159</u>			<u>395,082</u>	<u>12,895,717</u>
Total Expenditures & Transfers-Out	\$ <u>2,688,942</u>	\$ <u>123,684,802</u>	\$ <u>156,117,918</u>	\$ <u>1,941,347</u>	\$ <u>677,010</u>	\$ <u>9,170,482</u>	\$ <u>294,280,501</u>
EXPENDITURES & TRANSFERS-OUT BY FUND							
General Fund	\$ 1,841,611	\$ 11,207,810	\$ 14,057,422		\$ 677,010	\$ 6,078,471	\$ 33,862,324
State Special Revenue Fund	731,346	73,382,901	15,851,895	\$ 1,843,249		2,495,215	94,304,605
Federal Special Revenue Fund	115,985	367,428	8,910,608	98,098		590,943	10,083,062
Debt Service Fund		38,726,664				5,853	38,732,517
Internal Service Fund			937,916				937,916
Permanent Fund			116,360,077				116,360,077
Total Expenditures & Transfers-Out	<u>2,688,942</u>	<u>123,684,802</u>	<u>156,117,918</u>	<u>1,941,347</u>	<u>677,010</u>	<u>9,170,482</u>	<u>294,280,501</u>
Less: Nonbudgeted Expenditures & Transfers-Out	23,479	102,276,437	119,688,872	(570)	(368)	79,895	222,067,745
Prior Year Expenditures & Transfers-Out Adjustments	(332)	461,071	5,754,659		210	(165,142)	6,050,466
Actual Budgeted Expenditures & Transfers-Out	<u>2,665,795</u>	<u>20,947,294</u>	<u>30,674,387</u>	<u>1,941,917</u>	<u>677,168</u>	<u>9,255,729</u>	<u>66,162,290</u>
Budget Authority	<u>2,919,527</u>	<u>22,626,778</u>	<u>37,868,990</u>	<u>2,303,486</u>	<u>677,168</u>	<u>12,342,223</u>	<u>78,738,172</u>
Unspent Budget Authority	\$ <u>253,732</u>	\$ <u>1,679,484</u>	\$ <u>7,194,603</u>	\$ <u>361,569</u>	\$ <u>0</u>	\$ <u>3,086,494</u>	\$ <u>12,575,882</u>
UNSPENT BUDGET AUTHORITY BY FUND							
General Fund	\$ 30,132	\$ 88,612	\$ 87,522			\$ 7,004	\$ 213,270
State Special Revenue Fund	223,600	1,540,080	990,528	\$ 349,667		2,614,442	5,718,317
Federal Special Revenue Fund		50,792	6,057,108	11,902		465,048	6,584,850
Internal Service Fund			59,445				59,445
Unspent Budget Authority	\$ <u>253,732</u>	\$ <u>1,679,484</u>	\$ <u>7,194,603</u>	\$ <u>361,569</u>	\$ <u>0</u>	\$ <u>3,086,494</u>	\$ <u>12,575,882</u>

This schedule is prepared from the Statewide Accounting, Budgeting, and Human Resources System (SABHRS) without adjustment. Additional information is provided in the notes to the financial schedules beginning on page A-11.

Department of Natural Resources and Conservation

Notes to the Financial Schedules

For the Two Fiscal Years Ended June 30, 2006

1. Summary of Significant Accounting Policies

Basis of Accounting

The department uses the modified accrual basis of accounting, as defined by state accounting policy, for its Governmental fund category (General, State Special Revenue, Federal Special Revenue, Debt Service, and Permanent). In applying the modified accrual basis, the department records:

Revenues when it receives cash or when receipts are realizable, measurable, earned, and available to pay current period liabilities.

Expenditures for valid obligations when the department incurs the related liability and it is measurable, with the exception of the cost of employees' annual and sick leave. State accounting policy requires the department to record the cost of employees' annual leave and sick leave when used or paid.

The department uses accrual basis accounting for its Proprietary and Fiduciary fund categories. Under the accrual basis, as defined by state accounting policy, the department records revenues in the accounting period when realizable, measurable, and earned, and records expenses in the period incurred when measurable.

Expenditures and expenses may include: entire budgeted service contracts even though the department receives the services in a subsequent fiscal year; goods ordered with a purchase order before fiscal year-end, but not received as of fiscal year-end; and equipment ordered with a purchase order before fiscal year-end.

Basis of Presentation

The financial schedule format is in accordance with the policy of the Legislative Audit Committee. The financial schedules are prepared from the transactions posted to the state's accounting system without adjustment.

Notes to the Financial Schedules

Department accounts are organized in funds according to state law applicable at the time transactions were recorded. The department uses the following funds:

Governmental Fund Category

General Fund – to account for all financial resources except those required to be accounted for in another fund.

State Special Revenue Fund – to account for proceeds of specific revenue sources that are legally restricted to expenditures for specific purposes. Department State Special Revenue Funds include Forestry operations, Wastewater and Drinking Water Projects, and the Renewable Resource Grants and Loans Program.

Federal Special Revenue Fund – to account for federal funds received by the department. The department's fire operations and suppression efforts are financed in part by federal funds.

Debt Service Fund – to account for accumulated resources for the payment of general long-term debt principal and interest. The department uses this fund for the bonds issued to provide funding for renewable resources, coal severance tax, and water development projects.

Permanent Fund – to account for financial resources that are legally restricted to the extent that only earnings, and not principal, may be used for purposes that support the department's programs. The department uses this fund for the Common School Trust, university and college trusts, Morrill Trust, School for the Deaf and Blind Trust, State Reform School Trust, Capitol Building Trust, and the Trust and Legacy Account.

Proprietary Fund Category

Internal Service Fund – to account for the financing of goods or services provided by one department or agency to other departments or agencies of state government or to other governmental entities on a cost-reimbursement basis. The department's Internal Service Fund contains the Forestry Division's Air Operations Bureau. The Air Operations Bureau maintains and operates aircraft to aid in fire suppression.

Notes to the Financial Schedules

Enterprise Fund – to account for operations (a) financed and operated in a manner similar to private business enterprises, where the Legislature intends that the department finance or recover costs primarily through user charges; or (b) where the Legislature has decided that periodic determination of revenues earned, expenses incurred or net income is appropriate for capital maintenance, public policy, management control, accountability, or other purposes. The 2005 Legislature directed the department establish an Enterprise Fund for the State Nursery Program in fiscal year 2005-06. In fiscal year 2004-05, these operations were recorded in the State Special Revenue Fund.

Fiduciary Fund Category

Agency Fund – to account for resources held by the state in a custodial capacity. The department's Agency Funds account for activity such as protested oil and gas royalties, non-land grant interest and income, and hazard reduction.

2. General Fund Balance

The negative fund balance in the General Fund does not indicate overspent appropriation authority. Each agency has authority to pay obligations from the statewide General Fund within its appropriation limits. Each agency expends cash or other assets from the statewide fund when it pays General Fund obligations. The department's outstanding liabilities exceed the assets the agency has placed in the fund, resulting in negative ending General Fund balances for each of the two fiscal years ended June 30, 2005 and June 30, 2006.

3. Federal Special Revenue Fund Balance

The negative fund balance in the Federal Special Revenue Fund does not indicate overspent funds. Two of the department's funds are shared with other agencies. The department records expenditures and the other agencies record revenue in the funds. The financial schedules only include the department's expenditures, not the other agency revenues. Therefore, the fund balance at July 1, 2004 and June 30, 2005, is negative on the Schedule of Fund Balances & Property Held in Trust.

4. Direct Entries to Fund Balance

Direct entries to fund balances in the General, State Special Revenue, Federal Special Revenue, Debt Service, and Permanent

Notes to the Financial Schedules

funds include entries generated by SABHRS to reflect the flow of resources within individual funds shared by separate agencies.

5. Negative Revenues

The negative Charges for Services revenue of \$31,749,747 in the Federal Special Revenue Fund in fiscal year 2004-05 reflects the reclassification and abatement of certain fire-related revenue transactions. Prior Year Revenues & Transfers-In Adjustments of \$11,958,789 were processed to reclassify Charges for Services revenue collected in previous years as Federal revenue. The department also abated a Federal revenue accrual of \$19,790,958 in a shared fund as the revenue was subsequently received by the Department of Military Affairs.

6. Long-Term Debt

During fiscal year 2004-05, the state of Montana issued General Obligation Drinking Water State Revolving Fund Program 2005F Series bonds for \$3,875,000. These bonds were used for Drinking Water project loans. The state of Montana issued General Obligation Water Pollution Control State Revolving Fund Program 2005G Series bonds for \$2,110,000. These bonds were used for Water Pollution project loans. At June 30, 2006, the department had a total of \$31,875,000 in General Obligation bonds outstanding.

The department issued Coal Severance Tax (CST) 2004 Refunding Series A bonds for \$5,070,000. This bond issue was used to refund CST 1996 Series A. The department issued CST 2004 Series B taxable bonds for \$430,000 to fund the North Fork of the Smith River Irrigation Project. At June 30, 2006, the department had a total of \$33,370,000 of CST bonds outstanding.

The department has a loan from the U.S. Bureau of Reclamation to fund the Middle Creek Dam project. The unpaid loan principal as of June 30, 2006, was \$2,791,221.

The Northern Cheyenne Tribe and the department entered into an agreement on July 1, 1994, in which the tribe agreed to loan the state up to \$11,500,000 of federal funds appropriated as part of the Northern Cheyenne Indian Reserved Water Rights Settlement.

Notes to the Financial Schedules

The non-interest bearing loan was used to help finance the costs of the Tongue River Dam Project. The actual amount of the loan was \$11,300,000. The outstanding loan balance at June 30, 2006, was \$9,271,795. In March 2004, the department issued a Coal Severance Tax 2004 Series A bond to the tribe for \$9,851,282 as security for the loan. The bond, which is non-interest bearing, provides a means of repayment to the tribe in the event pledged revenues are insufficient for loan repayment.

7. Other Financing Sources

The Schedules of Total Revenues and Transfers-In contain the following activity in the other financing sources class:

State Special Revenue Fund – A portion of this activity is the transfer of Common School Permanent Trust Fund earnings to the Guarantee Account for distribution to school districts. Transfers-In activity also includes the movement of loans receivable from other funds and the transfer of federal funds from the Department of Environmental Quality for the Clean Water and Drinking Water State Revolving Funds.

Debt Service Fund – This activity is comprised of the movement of loans receivable from other funds.

Permanent Fund – This activity represents the allocation of interest and income within the trust funds administered by the department.

8. Trust Land Management Division

The Trust Land Management Division manages trust lands granted to the state of Montana by the Enabling Act of 1889. Division expenditures were reported as part of the Forestry and Trust Lands program on the Schedule of Total Expenditures and Transfers-Out for fiscal year 2004-05. The expenditures in the Permanent Fund are reported in the Trust Funds program on the Schedule of Total Expenditures and Transfers-Out for fiscal year 2005-06.

Department Response

DNRC RESPONSE TO FY 05/06 LEGISLATIVE AUDIT

1) We recommend the Department:

A. Seek legislation to provide a funding source for the administrative costs of the Morrill Trust.

Concur. EQC has adopted LC 8989 that will address this recommendation.

B. Seek legislation to exclude the Morrill Trust from administration account deposit requirements.

Concur. EQC has adopted LC 8989 that will address this recommendation.

C. Repay the \$507,643 inappropriately withheld from Morrill Trust revenues, plus accrued interest, to the Morrill Trust and its beneficiary, Montana State University.

Partially Concur: DNRC will make a request to OBPP to include \$507,643 (principal only) in its 2008/2009 budget for reimbursing the Morrill Grant for monies withheld in compliance with Montana state law. However, this request does not concede the legal assertion that DNRC's compliance with previous and existing state law is unconstitutional. Statutes are deemed to be constitutional unless determined otherwise by a Montana court.

D. Repay the \$244,900 inappropriately withheld from Common School, University of Montana, Montana State University – second grant, Montana Tech, State Normal School, School for the Deaf and Blind, State Reform School, and Capitol Building Trust revenues, plus accrued interest to the trusts and their beneficiaries.

Partially Concur: Department will make a request to OBPP to include \$52,955 in its 2008/2009 budget for monies withheld from the identified trusts other than common schools. Common schools have already been compensated by the general fund for the identified amount of \$191,945. The LAD report explains this offsetting relationship between general fund and common school trust revenue (Page 17, paragraph 1). Therefore, the department believes that no further compensation action by the department for common schools is warranted.

2) We recommend the department:

A. Establish procedures to allocate administration costs affecting a single trust to the affected trust.

Concur. The department has revised its procedure to specifically account for single trust legislative appropriations.

B. Repay the \$15,406 inappropriately withheld from University of Montana, Montana State University – second grant, Montana Tech, State Normal

School, School for the Deaf and Blind, State Reform School, and Capitol Building Trust revenues, plus accrued interest to the trusts and their beneficiaries.

Concur. The department will correct this error by October 31, 2006.

3) We recommend the department:

A. Seek legislation to establish a mechanism for funding the Trust Land Administration Account when initial allocations exceed maximum deposit amounts.

Concur. The department has already submitted proposed trust land funding legislation to OBPP to address this recommendation.

B. Repay the \$215,631 inappropriately withheld from Common School Trust revenues, plus accrued interest, to the Common School Trust and its beneficiaries.

Do Not Concur: Common schools have already been compensated by the general fund for the identified amount of \$215,631. The LAD report explains this offsetting relationship between general fund and common school trust revenue (Page 17, paragraph 1). Therefore, the department believes that no further compensation action by the department for common schools is warranted.

4) We recommend the department:

A. Maintain expenditure records in sufficient detail to identify the administration costs incurred for the benefit of each trust, and

Concur: The department believes it does maintain expenditure records in sufficient detail to reasonably allocate management costs devoted to the benefit of each trust. The LAD report found that the department identifies costs by each type of land use. The department therefore utilizes land use revenue by trust to allocate land use costs. The commonality and consistency of department management by land use activity logically supports this methodology as a reasonable procedure to fairly and equitably apportion costs. However, the department will review the suggestions outlined in Recommendation 4 and look for ways to improve its cost accounting by each trust.

B. Evaluate the expenditure data to ensure each land trust's administration charges are reasonable and, if necessary, develop another allocation method that results in reasonable charges.

Concur. The department will review and evaluate management expenses throughout the current fiscal year.

5) We recommend the department discontinue diverting revenues on one trust to pay administrative costs allocated to other trusts.

Concur: See response to 4A.

6) We recommend the department limit charges to its appropriations to purposes specified in appropriation laws.

Concur. The Department has made the correction through a prior year adjustment.

7) **We recommend the department process surface and ground water rights applications in the timeframes required by state law.**

Concur. These deadlines were based on the level of activity and water use development methods that were present in 1973. Since then several water basins have been closed to various uses of water and applications for groundwater and for changing and leasing existing water rights have profoundly increased in complexity. More applications are receiving objections and applications are reviewed for impacts under MEPA. We hired an additional hearings examiner October 2006 to help reduce the backlog of hearings to be held. Montana Courts have ruled these deadlines are “advisory”; they are not fatal to the Department’s jurisdiction or the applicant’s standing.

8) **We recommend the department comply with section 17-1-1-2, MCA, by establishing procedures to ensure distributions of unrealized investment losses are properly classified on the state’s accounting records.**

Concur. The Department has made the correction through a prior year adjustment and placed procedures within our fiscal year-end processing manual.

Disclosure Issue: State law prescribes a different basis for determining the maximum appropriation and deposit amounts related to the Capitol Building Trust, potentially resulting in an inequitable allocation of costs.

Partially concur. Unlike the other trusts, the Capitol Building Trust does not have a permanent fund. Pursuant to 77-1-108 and -109, the other trusts use a percentage of permanent fund balance to calculate revenues available for the Trust Land Administration Account, while the Capitol Building formula uses a percentage of eligible revenue. These formulas complicate the process of allocating expenses to individual trusts. The department has already submitted proposed trust land funding legislation to OBPP to address this issue in the future. The LAD review found two occurrences, which are presented in the report as audit recommendations 2 and 3. The Department has responded to each of these above.

The Department does not concur with the analysis presented in paragraph two. The LAD review shows variations in the percentage of each trust’s total revenue that is contributing to the trust land administration account. These variations are presented to infer funding of activities by trust may be inequitable. Trust land management is currently funded from several sources, each tied to certain management activities: trust land administration account, commercial leasing account, resource development account, timber sale account, forest improvement account and recreational use account. Calculating a percentage contribution to

one funding account based on revenue from all land uses is therefore inappropriate, and runs counter to the audit's specific finding and recommendations to take steps to further verify equitable apportionment of costs by trust and land use.